Internal Revenue Service **Department of the Treasury**

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5–PLR-105349–01
Date:
May 30, 2001

,

In re:

LEGEND

Taxpayer	=	
Transferor	=	
State	=	
City	=	
Plant	=	
a	=	
b	=	
c	=	
d	=	
Date 1	=	
Date 2	=	

Dear :

This letter responds to your letter dated December 18, 2000, and subsequent correspondence submitted on behalf of Taxpayer, requesting a letter ruling concerning the treatment under §118 of the Internal Revenue Code of the transfer of certain interconnection equipment by Transferor to Taxpayer.

Taxpayer represents that the facts are as follows.

FACTS

Taxpayer is a regulated public utility located in State that is primarily engaged in the generation, transmission, and distribution of electricity to retail and wholesale customers.

Transferor is the owner and operator of a cogeneration facility (Facility) that is an integral part of Transferor's Plant located in City. The Facility is a qualified facility, as defined in section 3 of the Federal Power Act, as amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 (PURPA). On Date 1, the Federal Energy Regulatory Commission (FERC) assigned to the Facility the qualifying facility identification number of a.

The Facility began operation in Date 2. The Facility and the Plant are operated as an integrated facility that is isolated from Taxpayer's transmission grid. The Facility has approximately b megawatts of excess, as available electric power that can be either sold at avoided cost to Taxpayer or delivered and sold to wholesale markets as permitted under PURPA and the Energy Policy Act of 1992.

Taxpayer will construct certain interconnection facilities (Interconnection Facilities) at Transferor's sole expense. After the construction is complete, Transferor will transfer ownership of the Interconnection Facilities to Taxpayer. Thereafter, the Interconnection Facilities will be owned, operated, and maintained by Taxpayer at its expense. The Interconnection Facilities will not be included in Taxpayer's rate base, and Taxpayer will not earn a return on the cost of constructing the Interconnection Facilities. For regulatory accounting purposes, Taxpayer will not include the cost of the Interconnection Facilities in its regulatory expenses nor will it include the reimbursement from Transferor of these costs in its regulatory income.

Taxpayer and Transferor have entered into a long-term power purchase agreement (PPA) for the purchase of electricity from the Facility. The PPA has an initial term of 10 years.

Further, Taxpayer and Transferor have entered into an Interconnection and Operating Agreement (IOA) pursuant to Taxpayer's Open Access Transmission Tariff filed with FERC. The purpose of the IOA is to allow Transferor to deliver energy to FERC approved power marketers for sale to other entities. Transferor will sell approximately c percent or more (but in no event less than d percent) of the electric power from the Facility on an annual basis to Taxpayer under the terms of the PPA, with the remainder being sold to wholesale purchasers pursuant to the IOA.

Transferor does not anticipate the need to purchase power from Taxpayer; however, Transferor certifies that if such purchases are made during the initial 10–year term of the PPA, such purchases are not expected to exceed 5 percent of the projected total power flows over the Interconnection Facilities.

Taxpayer further represents that the characteristics described below are present with respect to the contemplated contributions by Transferor to Taxpayer. First, the Interconnection Facilities contributed by Transferor to Taxpayer will become a permanent part of Taxpayer's transmission system. Second, the contribution is not compensation for services provided for Transferor by Taxpayer. Third, the contribution is a bargained-for-exchange because Taxpayer and Transferor entered into the necessary agreements willingly and at arm's length. Fourth, the contribution will foreseeably result in a benefit to Taxpayer commensurate will its value because the Interconnection Facilities will become part of its transmission system. Fifth, the Interconnection Facilities will be used by Taxpayer in its trade or business to produce income.

RULING REQUESTED

Taxpayer requests the Service to rule that the transfer of the Interconnection Facilities by Transferor to Taxpayer will not be a contribution in aid of construction (CIAC) under §118(b) and will be excludable from Taxpayer's gross income as a contribution to capital under § 118(a).

LAW AND ANALYSIS

Section 118(a) provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. Section 118(b), as amended by § 824(a) of the Tax Reform Act of 1986 (the 1986 Act), provides that for purposes of exclusion under § 118(a), except as provided in § 118(c), a contribution to the capital of taxpayer does not include any CIAC or any other contribution as a customer or potential customer.

Section 1.118–1 of the Income Tax Regulations provides, in part, that § 118 applies to contributions to capital made by persons other than shareholders. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid to induce the taxpayer to limit production.

Notice 88–129, 1988–2 C.B. 541, as modified by Notice 90–60, 1990–2 C.B. 345, provides specific guidance with respect to the treatment of certain payments or transfers of property to regulated public utilities by qualifying small power producers and qualifying cogenerators (collectively, Qualifying Facilities), as defined in section 3 of the Federal Power Act, as amended by section 201 of PURPA.

The amendment of § 118(b) by the 1986 Act was intended to require utilities to include in income the value of any CIACs made to encourage the provision of services by a utility to a customer. See H.R. Rep. No. 841, 99th Cong., 2d Sess. 324 (1986). In a CIAC transaction, the purpose of the contribution of property to the utility is to facilitate the sale of power by the utility to a customer. In contrast, the purpose of the contribution by a Qualifying Facility to a utility is to permit the sale of power by the Qualifying Facility to the utility. Accordingly, the fact that the 1986 amendments to § 118(b) render CIAC transactions taxable to the utility does not require a similar conclusion with respect to transfers from Qualifying Facilities to utilities.

Notice 88–129 provides, in part, that with respect to transfers made by a Qualifying Facility to a utility exclusively in connection with the sale of electricity by the Qualifying Facility to the utility, a utility will not realize income upon transfer of interconnection equipment (intertie) by a Qualifying Facility. The possibility that an intertie may be used to transmit power to a utility that will in turn transmit the power across its transmission network for sale by the Qualifying Facility to another utility (wheeling) shall not cause the contribution to be treated as a CIAC.

Further, the notice provides, in part, that a transfer from a Qualifying Facility to a utility will not be treated as a Qualifying Facility transfer (QF transfer) under this notice to the extent the intertie is included in the utility's rate base. Moreover, a transfer of an intertie to a utility will not be treated as a QF transfer under this notice if the term of the power purchase contract is less than ten years.

The notice also provides, in part, that a utility that constructs an intertie in exchange for a cash payment from a Qualifying Facility pursuant to a PURPA contract will be deemed to construct the property under contract and will recognize income from the construction in the same manner as any other taxpayer constructing similar property under contract. Subsequent to the construction of the property, the Qualifying Facility will be deemed to transfer the property to the utility in a QF transfer that will be treated in exactly the same manner as an in-kind QF transfer.

In the instant case, the transfer of the Interconnection Facilities is subject to the guidance set forth in Notice 88–129 and Notice 90–60 for the following reasons: (1) the Facility is a PURPA qualified facility; (2) Transferor and Taxpayer have entered into a long-term PPA with an initial term of 10 years; (3) the Interconnection Facilities will be used predominantly in connection with the sale of electricity by Transferor to the Taxpayer pursuant to the long-term PPA; (4) the transfer of the Interconnection Facilities by Transferor to Taxpayer will not be included in Taxpayer's rate base; and (5) no more than 5 percent of the projected total power flow over the Interconnection Facilities will flow to Transferor during the first ten taxable years of Taxpayer, beginning with the year in which the Interconnection Facilities are placed in service.

Accordingly, based solely on the representations and the relevant law set forth above, we rule that the transfer of the Interconnection Facilities by Transferor to Taxpayer meets the safe harbor requirements of Notice 88–129, and therefore, will not be a CIAC under § 118(b). However, Taxpayer will be required to recognize income attributable to the receipt of the transferred property if the safe harbor is terminated. See the provisions of Notice 88–129.

Next, we must decide whether the contribution qualifies as a contribution to capital under § 118(a).

The legislative history of § 118 provides, in part, as follows:

> This [§ 118] in effect places in the Code the Court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

S. Rep. No. 1622, 83d Cong., 2d Sess. 18–19 (1954).

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes, were part of the price of service rather than contributions to capital. The case concerned customers' payments to a utility company for the estimated cost of constructing service facilities (primary power lines) that the utility company otherwise was not obligated to provide. The customers intended no contribution to the company's capital.

Later, in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), the Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. Id. at 591.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The Court recognized that the holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co. The Court in Chicago, Burlington & Quincy Railroad Co. found that the distinguishing characteristic between those two cases was the differing purpose motivating the respective transfers. In Brown Shoe Co., the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co., since the transfers were made with the purpose, not of receiving direct services or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in Chicago, Burlington & Quincy Railroad Co. also stated that there were other characteristics of a nonshareholder contribution to capital implicit in Detroit

Edison Co. and Brown Shoe Co. From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Fifth, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

The proposed transfer of the Interconnection Facilities by Transferor to Taxpayer possesses the characteristics of a nonshareholder contribution to capital as described in Chicago, Burlington & Quincy Railroad Co. First, the Interconnection Facilities contributed by Transferor to Taxpayer will become a permanent part of Taxpayer's transmission system. Second, the contribution is not compensation for services provided for Transferor by Taxpayer. Third, the contribution is a bargained-for-exchange because Taxpayer and Transferor entered into the necessary agreements willingly and at arm's length. Fourth, the contribution will foreseeably result in a benefit to Taxpayer commensurate will its value because the Interconnection Facilities will become part of its transmission system. Fifth, the Interconnection Facilities will be used by Taxpayer in its trade or business to produce income.

Therefore, Taxpayer's receipt from Transferor of the Interconnection Facilities will be a contribution to capital under § 118(a).

Accordingly, based on the foregoing analysis and the representations made by Taxpayer and Transferor, we rule that the transfer of the Interconnection Facilities by Transferor to Taxpayer will not be a CIAC under § 118(b) and will be excludable from the gross income of Taxpayer as a contribution to capital under § 118(a).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Walter H. Woo
Senior Technician Review, Branch 5
Office of Associate Chief Counsel, Passthroughs and Special Industries

cc: Industry Director, Natural Resources (LM:NR)